



State of Rhode Island  
Office of the General Treasurer  
State House – Room 102  
Providence, Rhode Island 02903

**Seth Magaziner**  
General Treasurer

March 15, 2022

Honorable Marvin L. Abney, Chair  
House Committee on Finance

**Re: H7499- An Act Authorizing the City of Providence to Finance a Contribution Towards the Unfunded Pension Liability of the Employee Retirement System of the City of Providence by the Issuance of Bonds in a Principal Amount Not to Exceed \$515,000,000**

Dear Chair Abney,

As General Treasurer, my priority is to promote economic growth and financial security for all Rhode Islanders. Everyone in our state deserves a secure retirement, including those who have spent their careers serving the community as first responders and municipal workers.

Under the stewardship of our administration, the health of the State pension system, which includes over one hundred municipal pension plans, has improved significantly. The funded status of the system has reached its highest level in over a decade, and the investment performance of the system in 2021 was stronger than 92% of public pension plans nationally.

Additionally, in recent years, we have worked with the cities of Central Falls and West Warwick to develop plans to put their critically funded pension systems on a sustainable and secure path.

With this experience we offer the following commentary on H7499, regarding a proposed pension obligation bond (POB) for the City of Providence.

First, we credit Mayor Jorge Elorza and the Providence City Council for the process that went into developing this proposal, particularly the convening of stakeholders and experts and for engaging the public.

That said, the legislation that has been submitted requires careful scrutiny by the General Assembly given the scale of the proposal and the risks associated with POBs. To assist the General Assembly in its deliberations, our Office offers the following observations and recommendations:

- **Pension obligation bonds often reduce costs over time, but still carry a risk of higher costs.**

The primary argument in favor of POBs is that money can be borrowed at a low interest rate, and then invested in the financial markets as part of a pension fund, earning a higher investment return than the

cost of borrowing. The difference between the cost of borrowing money and the higher investment return of the invested proceeds, known as “arbitrage”, produces a net profit for the issuer that reduces budget pressure over time.

Thus, POBs do not reduce the liability the pension plan sponsor (in this case the City of Providence) owes to pensioners, but often can reduce budget pressure faced by sponsors.

Historically, across most periods, the return of a typical diversified 60% stock / 40% bond investment portfolio has been higher than the interest rate of municipal bonds, and therefore POBs have succeeded in producing budgetary relief for issuers more often than not.

However, while typical pension investment portfolios may outperform the interest rate of municipal bonds over most time horizons, it has not been true over every time horizon. Timing is important, and if proceeds from a POB are invested shortly before a significant stock market decline, investment earnings may fall short of the cost of borrowing the POB. A scenario like this would increase total costs to the issuer over time. There are numerous examples of POBs hurting the financial conditions of municipalities rather than helping, most notably playing a role in the municipal bankruptcies in Detroit, MI and Stockton, CA. Most of our recommendations are aimed at maximizing the likelihood that the interest rate of a Providence POB will in fact be lower than the investment return of the bond proceeds.

- **In order to reduce the risk of an adverse outcome, we recommend that any legislative authorization a POB include the following “guardrail” provisions:**

- A provision forbidding the City from closing on a POB sale if the true interest cost (TIC) of the bonds exceeds 4.5%. Putting a cap on the allowable cost of borrowing increases the odds that the investment earnings of the proceeds will exceed the cost of borrowing.
- Require that no more than \$150 million of the proposed \$500 million POB authorization be issued in any six month period. By breaking up the issuance of the \$500 million authorization over several tranches, the risk of unfavorable investment timing is reduced.

An alternative approach that our Office also finds acceptable would be to issue the full \$500 million in one transaction, but to invest the proceeds in equities in a staggered schedule over 12-18 months. This approach may cause the City to forgo some investment earnings over that period, but would accomplish the goal of reducing equity market timing risk while protecting the City from the risk that interest rates rise in the coming years.

- Require the inclusion of at least one “call option” during the term of the bond, so that the City has the option to refinance the POB if it becomes feasible to achieve a lower interest rate.
- Reduce the authorized term of the bond from 30 years to 25 years.

Under the status quo, the amortization schedule of the City’s pension liability is 18 years, meaning that the City would pay off the unfunded liability of the pension system by 2040. In order to accomplish this, the City’s annual required contributions toward paying down the unfunded liability would grow at a 5.2% average annual rate, which is likely to be unsustainable.

Based on the documents published by the working group that developed the proposal, it appears that the City is considering issuing a POB with a significantly longer term than 18 years, and also reamortizing the remaining pension liability beyond 18 years. By pushing the payment schedule for the bond and the remaining pension liability further into the outyears, the City would increase further reduce budget pressure over the next 18 years, but would also increase outyear costs, potentially offsetting the total expected savings of the plan over the full term of the bond.

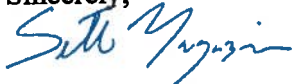
We recommend that the authorized term of the POB be limited to no more 25 years, recognizing the need for the City's annual liability servicing costs to be lowered to a sustainable growth rate, but also noting the importance of maintaining a sufficient likelihood of achieving total net savings over time.<sup>1</sup>

We also continue to recommend that the City negotiate with its bargaining units to bring the benefit structure of the Providence pension system in line with the State pension system. This will improve financial sustainability and reduce risk over the long run, while providing a fair and uniform landscape for public employees across the state.

Although no POB is ever completely risk-free, our Office believes that these recommendations will maximize the likelihood that savings will be achieved over time, relieving budget pressure for the City and strengthening the sustainability of the Providence pension system and the retirement security of its members.

Our Office commends all who have contributed the hard work and diligence to bring the proposal to the point, and we remain available as a resource to assist in any way.

Sincerely,



Seth Magaziner  
General Treasurer

cc: Honorable Members of the House Committee on Finance  
Honorable K. Joseph Shekarchi, Speaker of the House  
Honorable Scott A. Slater

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<sup>1</sup> The City projects that a 25 year POB term and 25 year amortization of the remaining liability will cause the total cost of the plan to be roughly breakeven on an undiscounted basis, and to generate approximately \$70 million of savings on a present value basis, using a discount rate of 4%. Discounting is an appropriate method of valuing the costs and benefits of POBs, as inflation will likely mean that a dollar will have less value years from now than it does today. We recommend using a discount rate closer to the long-term TIPS breakeven rate, currently roughly 3%, which projects present value savings closer to \$55 million.